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UNCERTAINTIES IN PERMISSIVE SOURCES OF DIVIDENDS UNDER PRESENT G. S. 55-116

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The inadequacies of the statutes of North Carolina now in effect pertaining to business corporations are not readily perceivable on a casual perusal of the black letter type, particularly if one's contact with the corporation laws is merely clerical or mechanical. But lawyers in North Carolina whose practice forces them to come to frequent grips with practical legal problems relating to corporations are keenly aware of those inadequacies. That is why the movement which culminated in the tentative enactment by the 1955 General Assembly of a new Business Corporation Act¹ (not to become effective until July 1, 1957) started as a grass roots movement from the Bar, particularly the lawyers in the larger cities with substantial corporate practice.²

Typical perhaps of the not readily perceivable inadequacies is that section of the statute relating to corporate dividends, G. S. 55-116,³ hereafter referred to as "the dividend section." On quick glance, the following text of the dividend section (being that portion of that section which precedes the "provisos" so commonly, if not too happily, characteristic of statutory style) does not look too bad:

"No corporation may declare and pay dividends except from the surplus or net profits arising from its business, or when its debts, whether due or not, exceed two-thirds of its assets, nor may it reduce, divide, withdraw or in any way pay to any stockholders any part of its capital stock except according to this chapter. . . ."

To overlook for the moment the debt ratio requirement, that text seems fairly clear—until one begins to put it to actual test in any situation except the most simple one, viz. where a corporation has set up as "capital stock" the entire amount of consideration received on the issuance of its shares (without stock watering), has over the years an accumulation of retained net profits (over and above all losses, whether

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¹ N. C. Sess. Laws 1955, ch. 1371.

² The movement got under way in 1948, when monthly meetings of interested lawyers were held in Raleigh under auspices of the General Statutes Commission.

³ This article will not deal with the unfortunate pitfalls in the compulsory dividend section, G. S. 55-115, of which many lawyers have been sharply critical. That is a story in itself.

relating to fixed assets or otherwise) and proceeds to pay dividends out of⁴ such accumulation.

To test the quoted language we shall resort to ten simple hypothetical cases, focussing particularly on the three concepts mentioned in the statute, viz., surplus, net profits and the integrity of capital stock. To keep the hypotheses simple, we shall assume that the corporation in question has only one class of stock and that, although there are corporate creditors, the corporation's assets are, and by the payment of the contemplated dividend would still be, far above the unique 3-to-2 ratio required by our statute between assets and debts.

*First hypothetical case: profits and watered stock.*⁵ Let us assume that the corporation started life with its "capital stock" watered by \$40,000 (it issued, say, shares of the aggregate par value of \$100,000 as fully paid and received therefor in cash and property an amount of consideration that could not in good faith be viewed as exceeding \$60,000); in each of the first three years the corporation has net income (after taxes) of \$10,000 per year but has as yet paid no dividends; accordingly, at the close of the third year the directors contemplate paying out \$10,000 in dividends. Would the payment be lawful?

Recall that the dividend statute forbids dividends except from "the surplus or net profits arising from its business." Does this mean that there are two funds available, no matter whether the word "surplus" was intended to be used as an adjective or as a noun in the quoted phrase? If "surplus" be viewed as a noun, then the two funds would be: (1) surplus, *i.e.*, presumably the excess of net assets (total assets minus debts) over the aggregate par value of the issued "capital stock," and (2) net profits even though there be no such surplus. In that event, regardless of whether "net profits" means the aggregate net income over all the years of operation or the net income of the current year, the proposed dividend in our hypothetical case would be lawful despite that the retained profits have not wiped out the original \$40,000 deficit, if deficit it be.

Likewise, if surplus be viewed as an adjective, again arguably two

⁴ We shall speak of dividends as paid "out of" a designated source (net profits, surplus, etc.) since that is the way lawyers, businessmen and even accountants (when they are not speaking technically) talk about it. Actually, cash dividends are paid "out of" *assets*—specifically, cash or, more specifically still, the bank account on which the dividend checks are drawn; they are not paid "out of" an item on the "liabilities" side of the balance sheet, such as "surplus." If one were to speak with technical accuracy one would not say "these dividends are paid from the corporation's surplus"; rather, one would say, "the amount of these dividends does not exceed the corporation's surplus."

⁵ We start with the watered stock hypothesis not because of any belief that this is a typical phenomenon of our corporations but simply because it happens to be the best start for testing the clarity of the statutory concepts that bear on the distributable fund.

funds are available under the dividend statute, for then the statute would be taken to read as follows: "no dividends except from the surplus profits or the net profits arising from the business." The argument then would be: the term "surplus profits" must mean something different from the term "net profits" used in the same sentence; so, "surplus profits" seems to mean the excess of net assets (total assets minus debts) over capital stock which exists by virtue of retained earnings over the years; that would leave for "net profits" two possible meanings: (1) the balance of retained profits over the years disregarding any non-operating deficit (such as arises from stock watering) or (2) the net profits of the current year. In our hypothetical case, either of these meanings of "net profits" would permit the contemplated dividend.

On the other hand, how does one know that a court would not reason as follows in interpreting the dividend statute: the terms "net profits" and "surplus" are used synonymously, no matter whether "surplus" is used as an adjective or as a noun; so, there is only one source of dividends under the statute, viz., profits that create an earned surplus? That would be viewing the statute either (1) as if it said, using "surplus" as an adjective: "no dividends shall be paid except from the net profits, that is to say, surplus profits," or (2) as if it said, viewing "surplus" as a noun: "no dividends shall be paid except from surplus, that is to say, net profits, meaning profits that create a net excess of assets over debts and capital stock." (One may note, in passing, that either interpretation would make our dividend statute one requiring some kind of profits before dividends can be paid.)

Well, which kind of dividend statute do the above quoted words reveal—a one-fund or a two-fund statute? At one time the New Jersey dividend statute was exactly like the North Carolina statute under discussion, except that it contained no debt-ratio limitation.⁶ Such a statute, said the New Jersey court, left "room to contend that the words 'net profits' were intended to be synonymous with the word 'surplus'";⁷ the North Carolina dividend statute, under this reasoning, would be a one-fund statute, presumably limited to earned surplus. (But the amendment of the statute by inserting a comma after the word "surplus" makes it a two-fund statute, that court held.⁸) Certain judicial remarks dropped in the only North Carolina case that contains a pertinent discussion of this subject would similarly indicate that the North Carolina dividend statute is a one-fund statute. In *Cannon v. Wiscasset Mills*

⁶ The North Carolina corporation law of 1901, which introduced the present dividend provisions, followed closely the famed New Jersey corporation law of 1896.

⁷ See *Goodnow v. American Writing Paper Co.*, 73 N. J. Eq. 692, 694, 69 Atl. 1014, 1015 (1908).

⁸ *Ibid.* By the comma, "surplus" presumably was intended to be understood as a noun. For a similar two-fund effect of a strategically placed comma, see *United States v. Riely*, 169 F. 2d 542 (4th Cir. 1948), cert. denied 335 U. S. 908 (1949).

Co.,⁹ Judge Connor observed that "the terms 'net profits' or 'surplus profits' have been defined as what remains after deducting from the present value of all the assets of a corporation the amount of all liabilities, including the capital stock."¹⁰ That judicial observation would lead to a *surplus* requirement under our dividend statute.¹¹ Query, however, how literally Judge Connor's observation should be taken, since (1) it was unnecessary to the decision,¹² (2) the definition would seem to be technically incorrect if it meant to view as distributable *profits* such surpluses as arise from paid-in surplus, reduction surplus and other unearned sources, (3) the definition is taken from a text statement which in turn rests on decisions now all over 40 years old (and much close thinking about dividend sources and the accounting concepts related thereto has taken place in the last 40 years) and (4) some of the cases on which that definition was based used such expressions, for propriety of dividends, as the "net increase upon the original investment"¹³—which in a watered-stock case is not necessarily the same thing as a surplus test. Nevertheless, a literal application of the quoted observation of Judge Connor would forbid dividends in our hypothesized watered-stock case; but even this is uncertain because, arguably, the watered stock liability of the holders of the watered stock is itself an asset of the corporation, at least under the trust fund theory.¹⁴

Up to this point we have discussed our first hypothetical case without considering that other aspect of the dividend statute, viz., that a corporation must not "reduce, divide, withdraw or in any way pay over to any stockholder any part of its capital stock except according to this chapter." But what is the "capital stock" of a corporation, particularly of a watered stock corporation? Learned writers tell us that capital

⁹ 195 N. C. 119, 141 S. E. 344 (1928).

¹⁰ *Id.* at 125, 141 S. E. at 348.

¹¹ Compare the remark of Ervin, J., in *Steele v. Locke Cotton Mills Co.*, 231 N. C. 636, 639, 58 S. E. 2d 620 (1950) that the method of determining what constitutes surplus or net profits available for dividends is prescribed by G. S. 55-115, which section in turn deals with mandatory declarations of dividends from *accumulated profits* in excess of any working capital that may have been formerly set aside over and above the capital stock paid in. This has overtones of viewing our statute as a *profits* statute. But, again, too much must not be read into isolated judicial observations.

¹² All that was necessary to decide, under the aspect of the case then being discussed by the court, was that it is entirely proper to determine the amount of "accumulated profits" (which under certain circumstances a corporation can be forced to pay out in dividends under G. S. 55-115) by taking into consideration the wear-and-tear depreciation of assets (as shown by a proper depreciation reserve) incurred in the operation of the business.

¹³ See *Crawford v. Roney*, 130 Ga. 515, 61 S. E. 117 (1908).

¹⁴ Many North Carolina decisions purport to embrace the trust fund theory. See *Gilmore v. Smathers*, 167 N. C. 440, 83 S. E. 823 (1914) and cases there cited. See *Clayton v. Ore Knob Copper Co.*, 109 N. C. 385, 14 S. E. 36 (1891) for an indication that watered stock liability may be a corporate asset.

stock is not a *res* but a *quantum*,¹⁵ i.e., a mathematical figure performing the legal function of setting a limit to withdrawal of assets by shareholders: if net assets would be below that figure upon making a distribution of assets to shareholders, the distribution is unlawful; and, we are told, quite properly, that the term should be used to refer only to the bookkeeping item carried on the "liability" side,¹⁶ which is ordinarily determined, when all the issued shares have par value, by the aggregate par value of the issued shares. The difficulty with the North Carolina dividend statute in this respect is that in the same breath it seems to use the term "capital stock" to mean *either* corporate assets or the item on the "liability"¹⁷ side of the balance sheet. When the statute forbids one to "divide, withdraw, or . . . pay to" the shareholders it seems to be addressed to *assets*; when it forbids one to "reduce" the capital stock, it could be addressed either to assets or to the mere mathematical bookkeeping *figure*. The awkward phraseology is traceable to an ancient New York statute of 1825¹⁸ and reflects an era before the advent of no-par shares, low par shares issued at a premium and the many different kinds of surplus forced us to think more accurately about corporations' legal capital.¹⁹

Now, then, in our hypothetical watered stock case, payment of the proposed dividend would not "reduce" the merely mathematical bookkeeping figure which is the *quantum* aspect of "capital stock"; that figure would remain the same even if the dividend were paid. But would the proposed payment "reduce, divide or pay to" the shareholders any part of the capital stock if the latter is thought of as a *res*? The protected *res* must be something other than the totality of the corporate assets, for there is always a corporate loss of assets when dividends are paid, whatever be their source. The protected *res* therefore must be (or at least some courts have so believed)²⁰ the capital *paid in*, at least in the situation where the subscribers of the shares have paid in all that they have agreed to pay in. In our hypothetical case *that* "capital stock" is not being syphoned off by the proposed dividends; only some of the profits earned are going to be paid out. Conceivably, then, the "capital

¹⁵ Ballantine & Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws*, 23 CALIF. L. REV. 229, 234 (1935).

¹⁶ STEVENS, CORPORATIONS 431 (2d ed. 1949).

¹⁷ For short we speak of the "liability" side of the balance sheet, as opposed to the "asset" side; for accuracy it should be called the "liability and net worth" side, with "capital stock" as one of the net worth items.

¹⁸ Laws of N. Y., 48th sess., ch. 325 (April 21, 1825).

¹⁹ The remarks of Stacy, J., concurring in *Person v. Board of State Tax Commissioners*, 184 N. C. 499, 115 S. E. 336 (1922), to the effect that, strictly speaking, capital stock means the bookkeeping item, were not addressed to the dividend statute; indeed, his remarks recognized that the term "capital stock" is used in many meanings in statutes.

²⁰ *Peters v. U. S. Mortgage Co.*, 13 Del. Ch. 11, 114 Atl. 598 (1921); *Goodnow v. American Writing Paper Co.*, 73 N. J. Eq. 692, 69 Atl. 1014 (1908).

stock" protected by our dividend statute is, in the case of watered stock, the amount agreed to be paid for the issued shares.²¹ The already noted judicial observation in the *Wiscasset Mills* case to the effect that under the dividend statute dividends can be paid only from the excess of net assets over "capital stock"²² does not necessarily establish the contrary; indeed, that observation was immediately followed by the remark that what must be deducted from total assets before getting at the dividend funds is "the capital stock of the corporation, *paid in* and outstanding."²³ (Italics supplied.)

Perhaps a dividend statute, like that under discussion, that forbids paying out the "capital stock" to shareholders should not be interpreted literally but, rather, recognized as a shorthand way of saying: "do not pay dividends when to do so would leave net assets (total assets minus debts) at a figure below the amount that has been or should have been entered on the books as a credit entry under the name capital stock (or by whatever name the 'cushion' is known)." But if "capital stock" is so construed and if the prohibition in the present dividend statute against dividends that are not from "the surplus or net profits arising from its business" were to mean that the only fund for dividends is some kind of surplus, as is perhaps suggested by the discussed remarks in the *Wiscasset Mill* case, then just what is added by the further prohibition in the statute against impairing capital stock?

Second hypothetical case: current profits, over-all operating loss. Let us assume that the corporation starts life with assets exactly equal to the credit-entry bookkeeping item "capital stock"; in the first three years it loses \$10,000 each year; in the fourth year it has net income (after taxes) of \$15,000; accordingly, at the close of the fourth year the directors contemplate paying out \$10,000 in dividends. Would the payment be lawful?

Much of the discussion under our first hypothetical case is again pertinent. But now there is an additional complication: from its operations *over the years* the corporation does *not* have a balance of profits over losses. To uphold the proposed dividend not only would the statutory phrase permitting dividends "from the surplus or net profits" have to make available two funds, *i.e.*, "net profits" as something different from "surplus," but one would have to give the term "net profits" the meaning: profits of the current year despite prior losses. Of course, if North Carolina dividend law on the point is deemed definitely clari-

²¹ In general, see KEHL, *CORPORATE DIVIDENDS* 46-49 (1941); Cf. BALLANTINE, *CORPORATIONS* 582-584 (rev. ed. 1946).

²² *Supra* pp. 263-264.

²³ *Cannon v. Wiscasset Mills Co.*, 195 N. C. 119, 125, 141 S. E. 344, 348 (1928). In the *Peters* case, *supra* n. 20, the court attached importance to the words "capital stock *paid in*" (italics supplied) in the dividend statute in reaching its decision.

fied and established (on the tenuous reed of the vulnerable observation in the *Wiscasset Mills* case²⁴) to the effect that the statute provides only *one* source and that source is surplus, then the proposed dividend cannot be upheld. (Even that is not absolutely certain, however; one careful study of corporate dividends suggests that under one theory the corporate capital which must not be impaired by dividends is the capital, or capital stock, as it stood at the beginning of the current accounting period, with such impairments as it may by then have suffered.²⁵ If so, then the remark in the *Wiscasset Mills* case that the fund for dividends is the excess of net assets over capital stock might still leave an opening for the validity of the proposed hypothetical dividend.)

But even if the dividend statute be viewed as a two-fund statute, with "net profits" as one of the alternatives, that still leaves the question: does "net profits" mean current-period profits despite prior-period losses? An affirmative answer is somewhat doubtful if, viewing "surplus" as a noun (see previous discussion), one were to view the statute as a two-fund statute reading as follows: no dividends except from surplus, or from net profits arising from the business.²⁶ And, in fact, a negative answer has been given under such a statute in New Jersey.²⁷ Under such a statute the term "net profits," as a source of dividends different from surplus (earned or otherwise), could with logical consistency mean the over-the-years net profits.²⁸ Nevertheless, dividends from current earnings have been held permissible despite capital impairment under statutes apparently no more favorable to such a position, e.g., a statute permitting dividends from "net earnings or from the surplus of its assets over its liabilities including capital"²⁹ or one allowing dividends "out of net earnings, or out of its net assets in excess of capital."³⁰ Indeed, the opinion has been expressed that the phrase "surplus or net profits" in our dividend statute means to make current profits available for dividends.³¹ On the other hand, an affirmative

²⁴ See discussion *supra* pp. 263-264.

²⁵ KEHL, CORPORATE DIVIDENDS 28-30, 49-52 (1941).

²⁶ But see KEHL, CORPORATE DIVIDENDS 49-52, 61-64 (1941).

²⁷ National Newark & Essex Banking Co. v. Durant Motor Co., 124 N. J. Eq. 213, 1 A. 2d 316 (1938); Lick v. United States Rubber Co., 39 F. Supp. 675 (D. N. J. 1941). Said the court in the latter case: "Where capital is impaired, annual net earnings, if insufficient to offset the impairment, do not constitute net profits." (The impairment had arisen from operating losses.)

²⁸ See also remarks of Ervin, J., note 11 *supra*.

²⁹ Brooks Equipment & Mfg. Co. v. United States, 95 F. Supp. 247 (Ct. Cls. 1951) (construing Tennessee statute).

³⁰ United States v. Reily, 169 F. 2d 542 (4th Cir. 1948) (construing Virginia statute).

³¹ See Sparger, *Profits, Surplus and the Payment of Dividends*, 8 N. C. L. REV. 14, 16, 21 (1929). Such interpretation, argued that writer, is borne out by the further provision in the statute that forbids dividends when debts exceed two-thirds of the assets, since (he argues) it is unlikely that a corporation in such event

answer seems quite possible, if, viewing the word "surplus" in our dividend statute as an adjective, one were to read the statute as follows: no dividends except from surplus profits or net profits. (See previous discussion, pp. 262-263.) But even then you cannot be sure; diverse views have been expressed over a statute permitting dividends "either from earned surplus or from net earnings."³² It may be noted that English cases hold, where the company articles permit dividends from "net profits," that dividends can be paid from current profits despite prior losses.³³

But, one will ask, does not the clause against impairment of capital stock in our dividend statute clearly prevent dividends from current earnings when capital is impaired? Not necessarily. Thus, English judges have reasoned that if the corporation has losses which cut into capital, capital to that extent has been lost, and if in the next year the corporation makes a profit for that year and proceeds to pay dividends not in excess of such profits, then it is *not* paying dividends out of the lost capital—you cannot in logic pay out of what was lost—hence the dividend would be out of profits.³⁴ Again, Virginia statutes which were construed by a federal court to permit dividends from current earnings despite previous losses³⁵ also contained a section forbidding directors to pay dividends out of capital. One might answer that the English reasoning above mentioned incorrectly visualizes capital as some sort of item or aggregate of items on the asset side of the balance sheet. But one must recall that the North Carolina dividend statute seems to make that same inartistic use of the term "capital stock." (See discussion *supra*, p. 265.)

If one were to object that using current profits for dividends, instead of retaining them to repair a prior deficit, is whittling away at the concept of "capital stock"—that cushion allegedly for the protection of creditors—one might be faced with the answer that the cushion can apparently be whittled away anyhow by a corporate move which creditors cannot veto, viz., by a capital reduction. There is little evidence to in-

would have a surplus. The present writer is not inclined to agree with the latter point; indeed, one reason that induced the General Stautes Commission to drop the debt-ratio requirement in the dividend section of the new Business Corporation Act was that information received by the Commission indicated that many enterprises (e.g. implement dealers) do business on a large debt ratio of goods purchased on credit or other borrowed capital.

³² *Grand Traverse Hotel Co. v. United States*, 79 F. Supp. 860 (W. D. Mich. 1948) (construing Michigan statute and holding current earnings to be available despite capital impairment); *contra*, *Senior Investment Corp.*, 2 T. C. 124 (1943).

³³ *Ammonia Soda Company Ltd. v. Chamberlain*, [1918] 1 Ch. 266. See also *Bolton v. Natal Land & Colonization Co.*, 2 Ch. D. 124 (1892); *Lee v. Neuchatel Asphalte Co.*, 41 Ch. Div. 1 (1889).

³⁴ In *Ammonia Soda Company Ltd. v. Chamberlain*, [1918] 1 Ch. 266, see opinion of Warrington, L. J. at p. 292, of Scrutton, L. J. at p. 296.

³⁵ Note 30 *supra*.

dicating that corporations of those jurisdictions which either by statute (e.g., California and Delaware) or by judicial decisions permit dividends from current earnings despite prior losses find greater difficulty in getting credit or have caused greater prejudice to creditors than corporations of other states. Nor is it a clinching argument to say that the very existence of a capital reduction provision in the corporation statutes (like our G. S. 55-66) shows a legislative intention to force resort to a capital reduction that wipes off prior losses before the earnings of subsequent years can be available for dividends; the decisions already noted permitting dividends from current profits despite a deficit from past losses involved corporations whose governing law also permitted capital reduction.³⁶

Third hypothetical case: current profits but greater "capital" losses.

Assume that at the beginning of the year, January 1, a corporation owning and renting out beach cottages had net assets exactly equal to its "capital stock"; that these assets consisted of a number of lots with beach cottages thereon; that one of these cottages was washed away and destroyed on January 2 by waves in a hurricane; that the cottage in question was properly on the books at \$15,000; that insurance did not cover that particular type of loss and that disregarding such loss the corporation makes from the other cottages a net profit of \$10,000 in that year. Can \$10,000 lawfully be paid out in dividends?

Much of what has already been said has a bearing on this third hypothetical case, since this one differs from the second only in that now there seems to be even more force in the argument that payment of the dividend would not be *out of* capital but would be out of accumulated profits, there being no over-all *operating* deficit. Indeed, the groping by English courts for a somewhat nebulous distinction between the loss of *fixed* capital and of *circulating* capital is perhaps a step toward a distinction between capital that *is* and capital that is *not* consumed in production of the income from which the dividend is paid. Thus, Lindley, L. J. observed: ". . . fixed capital may be sunk and lost, and yet the excess of current receipts over current payments may be divided [*i.e.*, paid out in dividends], but the floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law."³⁷ True, these remarks are addressed to whether or not there exist "profits" (or "net profits" under company articles), but they are relevant to our discussion because divi-

³⁶ *E.g.*, statutes permitting reduction of capital existed in Tennessee, Virginia, Michigan and England at the time of the dividends involved in the cases cited notes 29, 30, 32, 33 *supra*.

³⁷ See *Verner v. General & Commercial Investment Trust*, [1894] 2 Ch. 239, 266.

dends out of "capital" are apparently not deemed by the English courts to be out of profits. Again, as in the previous hypothetical case, query whether the existence of a statutory capital reduction provision, or of the peculiar North Carolina debt ratio requirement, would have a bearing here.

Fourth hypothetical case: the wasting asset problem: the corporation starts out with "capital stock" of \$100,000 and with \$100,000 of assets represented largely by an investment in timberlands upon which the corporation undertakes lumbering operations. In the first year it makes \$20,000 net profits before allowing for \$10,000 of depletion of the timber that has been cut down and marketed. Can it pay \$20,000 in dividends?

Of course, if the heretofore noted remarks in the *Wiscasset Mills* case definitely fix a surplus requirement for dividends, despite alternative plausible interpretations previously discussed, the answer would seem to be that the profits of \$20,000 are not lawfully payable in dividends (without a formal reduction of capital). Moreover, even if the statutory term "or net profits" seems to afford an alternative source of dividends, and even if depletion of wasting assets is not required to be deducted before calculating the divisible "profits,"³⁸ our statutory prohibition against impairment of capital might forbid such a dividend.³⁹ But you cannot be sure; under a statute that permitted dividends from "the surplus profits arising from the business" and which prohibited dividing, withdrawing or paying to the share holders any part of the capital stock (in short, a statute fully as restrictive as the North Carolina dividend statute, in these respects), the Supreme Court of California has said that a mining company "is not deemed to have divided its capital" by paying the profits out in dividends without allowance for depletion.⁴⁰ Apparently the thought is: if this be, in a sense, a return of capital, still it is an exception to the capital-impairment rule.⁴¹ Perhaps

³⁸ The leading case in general is *Lee v. Neuchatel Asphalte Co.*, 41 Ch. D. 1 (1889). There are no North Carolina decisions on the point.

³⁹ KEHL, *CORPORATE DIVIDENDS* (1941) 125-129. See *Federal Mining & Smelting Co. v. Wittenberg*, 15 Del. Ch. 408, 138 Atl. 347 (1927).

⁴⁰ See *Excelsior Water & Mining Co. v. Pierce*, 90 Cal. 131, 140-141, 27 Pac. 44, 46 (1891). The issue was director's liability, under the statute, for unlawful dividends. Perhaps the court's reasoning revealed by the quoted words was not essential to the holding that the director was not liable. See also *Mellon v. Mississippi Wire Glass Co.*, 77 N. J. Eq. 498, 78 Atl. 710 (1910) where the court said that the *Goodnow* case, note 7 *supra* (decided under a statute containing a prohibition like that of the North Carolina statute against drawing off capital) has adopted the wasting asset doctrine of the *Lee* case in England (note 38 *supra*). Cf., *Glover v. Thompson Connellsville Coke Co.*, 66 Prrr. L. J. 525, 527 (C. P. Alleg. Co. 1918); *Pardee v. Harwood Electric Co.*, 262 Pa. 68, 105 Atl. 48 (1918).

⁴¹ The foregoing general remarks are not meant to explore the ramifications of the wasting asset doctrine under the many distinctions and qualifications that close analysis of the cases from other jurisdictions would reveal. These remarks merely go to show that the present dividend statute, taken against the general background of concepts like the integrity of "capital" and "capital stock" does not give the answer, one way or the other.

the very existence of a debts-to-assets ratio requirement in our dividend statute affords such protection to creditors as would justify recognition of the so-called wasting-asset exception in dividend law.

Fifth hypothetical case: initial paid-in surplus. Assume that the corporation starts out with 10,000 shares, par value \$10 per share, issued at \$20 per share; \$100,000 is set up on the books as "paid-in surplus." At the end of the first year, the corporation breaks even—no profit, no loss—and the directors contemplate paying \$1.00 per share in dividends. Lawful?

If our dividend statute is to be construed to mean (see discussion, pp. 262-263: "no dividend shall be paid except from the surplus profits or net profits arising from the business," it is certainly arguable (perhaps even persuasive) that here there are neither surplus *profits* nor net *profits*.⁴² Similarly, the proposed dividend would not be lawful if the terms "surplus" and "net profits" are to be viewed as somehow synonymous and as amounting to an earned surplus requirement.⁴³ If, however, the word "surplus" in our dividend statute is used as a noun and is to be viewed as affording a dividend fund *different* from "net profits" (see previous discussion), a paid-in surplus would seem available for dividends, except for the phrase "arising from the business." That phrase raises two questions: (1) Does the phrase "arising from the business" refer back to, and therefore limit, "surplus"?⁴⁴ (2) If it does, is this a "surplus arising from the business"? The answers to both questions seem somewhat uncertain. For whatever the observation may be worth, one never sees the term "arising from the business" immediately following the word "surplus" in a dividend statute; it always seems to be tied up with the words "profits." If, however, one were to view the phrase "arising from the business" as referring back to "surplus," one may urge that it is hard to see how an original paid-in surplus is one "arising from the business"; the latter phrase seems more adapted to the results of activities in the course of operating the business. Nevertheless, one notes that a surplus arising from a capital reduction has been judicially viewed as available for dividends despite that the

⁴² *Merchants & Insurers Reporting Co. v. Schroeder*, 39 Cal. App. 226, 178 Pac. 540 (1918) (under a statute that directors must not pay dividends except from "surplus profits arising from the business.") But see first two cases cited in note 51 *infra*.

⁴³ See the discussion in the first hypothetical case, *supra*, and the remarks of Ervin, J., note 11 *supra*.

⁴⁴ A statutory phrase, stemming from the New York act of 1825 (note 18 *supra*) once rather prevalent was, "surplus profits arising from the business." Revision of corporate laws in this century have virtually abolished the phrase.

New Jersey has amended its corresponding dividend provisions, by inserting a comma, so as to forbid dividends except from "surplus, or net profits arising from the business." That seems to take care of this specific problem.

dividend source in question was quite clearly limited by the qualifying statutory phrase (which was not discussed) "arising from the business."⁴⁵

There is a remark in the *Wiscasset Mills* case which, taken by itself and out of context, seems to authorize dividends from paid-in surplus. Pointing out that dividends under the statute can be paid from "the surplus or net profits," the court went on to say: "The term 'net profits' or 'surplus profits' have been defined as what remains after deducting from the present value of all the assets of a corporation the amount of all the liabilities, including the capital stock."⁴⁶ That looks as if any surplus is available for dividends. But the court did not discuss (and actually had no reason under the facts of that case to discuss) the effect of the phrase "arising from the business." Indeed, it is also arguable from the court's above quoted remark that the court viewed the words of the statute "surplus or net profits" as if they were "surplus profits or net profits"—thus making only *profits* available for dividends.

Finally let us not overlook the possible claim (weak though it be) that the "capital stock" which must not be divided, withdrawn or paid to the stockholders is the original investment paid by the shareholders as consideration for the stock, since the term "capital stock" is apparently not used in the dividend statute with strict technical accuracy to mean the bookkeeping item on the liability side of the balance sheet. (See previous discussion.⁴⁷)

Sixth hypothetical case: the "equalization" paid-in surplus. Assume that the corporation started out with 1000 shares, par \$100 per share. Now, years later, the corporation is so highly successful that buyers will gladly pay \$150 per share. The corporation now issues another 1000 shares at \$150, creating a paid-in surplus of \$50,000. (As to earned surplus, let it be assumed either that the corporation had accumulated a substantial one or that it had paid out most of its profits in dividends—it is believed that the difference is immaterial for our problem.) The directors now contemplate paying a dividend on the outstanding 2000 shares which will not only exhaust any earned surplus but will also cut into the paid-in surplus. Permissible?

The problem is really much the same as that in the fifth hypothetical case, but with this new wrinkle; it can now be more plausibly urged that the paid-in surplus is one "arising from the business"; accordingly, even if those words of the statute be deemed to limit the statutory surplus available for dividends, they would not bar the proposed dividend. The argument would be that, unlike a paid-in surplus which is contributed at the very beginning of the business and which is in a sense

⁴⁵ See first two cases cited in note 51 *infra*.

⁴⁶ *Cannon v. Wiscasset Mills Co.*, 195 N. C. 119, 125, 141 S. E. 344, 348 (1928).

⁴⁷ See also note 54 *infra* and text thereto.

contributed "capital," the above-par amount of consideration being paid by the new shareholders is now a premium that they pay to equalize the participation of the old and new shareholders in the corporate surpluses or at least to equalize the participation of the old and new shareholders in the corporation's demonstrated earning power. Therefore, (the argument would go) it is a surplus "arising from the business." One New York case can perhaps be viewed as so holding under equally restrictive statutory language, which language, however, the court did not thoroughly discuss.⁴⁸

Seventh hypothetical case: dividends from reduction surplus. Let us suppose that the corporation starts out with assets of \$100,000 and "capital stock" of \$100,000 (say, 1000 issued shares, par value \$100 per share); as the year comes to a close, it appears that there will be a loss for the year and an over-all deficit of \$10,000; however, from a recent sale of some fixed assets at cost, there is \$20,000 in cash that is not needed for working capital. The directors contemplate reducing the "capital stock" by a charter amendment reducing the par value of the shares from \$100 per share to \$70 per share, and to pay out \$20,000 in dividends. Can this lawfully be done?

If our dividend statute is really a profits statute of some kind (earned surplus, etc.) (see previous discussion), the proposed dividend is clearly unlawful. But, one may argue, this very hypothetical case goes to show that our dividend statute should be construed to permit dividends from unearned surplus, at least from a reduction surplus, for this reason: since there is specific statutory authority for capital reduction in G. S. 55-66, which section in turn contemplates paying out corporate assets in connection with a capital reduction (e.g., by purchase of shares for retirement, G. S. 55-66(4), and since another clause in the dividend statute says that a corporation must not reduce or pay to the stockholders any part of the capital stock "*except* according to this chapter," a return of capital in connection with a capital reduction under G. S. 55-66 seems impliedly permitted. (Emphasis added.) Arguably, one of the very purposes of a statutory provision for capital reduction is to permit the return to the shareholders of capital deemed unessential to the business.⁴⁹ Furthermore, the suggestion in the *Wiscasset Mills* case that any excess in asset values over liabilities and capital stock is available for dividends⁵⁰ would tend to support this position, however

⁴⁸ *Equitable Life Assurance Society v. Union Pacific R. R.*, 212 N. Y. 360, 160 N. E. 92 (1914). The court did not discuss the pertinent statutes conceivably applicable to the Utah corporation there involved, but the statutes of both New York and Utah then limited dividends to "profits actually earned" or to "surplus profits arising from the business."

⁴⁹ BALLANTINE, CORPORATIONS 627 (rev. ed. 1946).

⁵⁰ See quotation from the *Wiscasset Mills* case, pp. 263-264 *supra*.

obiter the suggestion may have been. Moreover, cases in other jurisdictions have expressed the view that distributions from a surplus created by capital reduction is possible even under a *profits* statute—though in no case was careful attention given to the possible technical distinctions between *profits* and plain *surplus*.⁵¹

On the other hand, it might be argued that the prohibition in the dividend statute against reducing or paying to the stockholders any part of the capital stock "*except according to this chapter*" (emphasis added) means that a mere reduction of capital stock does not per se authorize *paying out* dividends from the ensuing reduction surplus; rather, you have to be able to point to a specific provision in the corporation law chapter that permits such paying out, and the mere authority in the capital reduction section to reduce capital stock by reducing par value is (unlike the permission to *purchase* shares for retirement) not a specific authorization for such a paying out. In keeping with this thought (the argument would continue), the purpose of the capital reduction permitting reduction of par value of the issued shares is simply to wipe out an existing deficit or a deficit created by a conservative-minded write down of fixed assets reflecting a decline in value, thus paving the way for dividends out of future profits. The double prohibition (*viz.* against payment otherwise than from profits—net profits or surplus profits—and against distributing any part of the "capital stock") could be harmonized (according to this argument) by making prospective net profits available for dividends only if an otherwise prohibitive deficit is wiped out by a statutory capital reduction.

Query whether one or the other of these conflicting interpretations must be viewed as too farfetched under the language of our dividend statute and the decisions thereunder. One recalls that the New Jersey court observed, of a dividend statute almost exactly like that of North Carolina in these respects (including a prohibition against reducing or paying to the stockholders any part of the capital stock except "as authorized by law"), that in the dividend statute in question the words "surplus" and "net profits" were, conceivably, synonymous.⁵²

Eighth hypothetical case: profits from disposal of a "capital asset."

⁵¹ See *Dominguez Land Corp. v. Daugherty*, 196 Cal. 453, 238 Pac. 697 (1925) and *Strong v. Brooklyn Cross-Town R. Co.*, 93 N. Y. 426 (1883), in both of which jurisdictions there existed at the time dividend statutes with the *double* prohibition: (1) dividends must not be paid except from "surplus profits arising from the business" and (2) dividends must not pay to the stockholders "any part of the capital stock" except as provided in the corporation law. Nevertheless, the court viewed a reduction surplus as available for dividends. Similarly, see *Benas v. Title Guaranty Trust Co.*, 216 Mo. App. 53, 267 S. W. 28 (St. L. Ct. App. 1924) where the dividend statute relating to trust companies permitted dividends from *profits*. (Mo. Rev. Stat. 1909, § 1132; Mo. Rev. Stat. 1919, § 11825).

⁵² See *Goodnow v. American Writing Paper Co.*, 73 N. J. Eq. 692, 694, 69 Atl. 1014, 1015 (1908) and discussion p. 263 *supra*.

Assume that the corporation starts off with \$200,000 of "capital stock" and net assets of \$200,000 consisting of two apartment houses in each of which the corporation has an investment of \$100,000. Now several years later, it sells one of these apartment houses for \$50,000 above the cost-less-depreciation figure at which this item was carried on the books. At the beginning of the period in which this sale took place there was no surplus and no deficit, and during that year the corporation breaks even on its other operations. Can the corporation lawfully pay \$50,000 (or any portion thereof) out in dividends?

Specifically, would the dividend be from "the surplus or net profits arising from the business"? Again, this raises many of the problems already noted, both as to what sources are available and whether they are qualified by the italicized phrase, to which there seems to be no clear answer. If the limiting phrase refers to *any* dividend source made available by the statute (whatever the source be—see previous discussion), would the surplus and/or profits in question be "arising from the business"? Or does that phrase contemplate gains from ordinary and recurrent transactions of the kind usually incident to the business? Is the gain to be really treated as "ordinary current profits," as one New York case indicates?⁵³

The other prohibition in the statute, viz., against dividing, withdrawing or paying to the shareholders any part of the "capital stock" presumably would seem not to be violated by the dividend under discussion, even if "capital stock" be interpreted to mean the amount of the original investment.⁵⁴

Ninth hypothetical case: unrealized appreciation. Suppose that the corporation's assets consist wholly of building lots and apartment houses which it acquired some years before and which it carries on the book at cost less depreciation (physical) and that it starts off the year with no deficit or surplus. Because of increased values of the apartment houses and of some of the lots, those lots and apartment houses can now be sold for \$100,000 above book value, as shown by bona fide offers. Accordingly, the directors write up the properties in question by \$100,000, crediting \$100,000 to "surplus." Thereupon the corporation sells at cost some of the lots (which it had not written up) for \$20,000 in cash, which cash they contemplate paying out in dividends, having no other source thereof than the said "surplus." A lawful dividend?

If our dividend statute is viewed as basically a profit statute,⁵⁵ then

⁵³ *Equitable Life Assurance Society v. Union Pacific R. R.*, 212 N. Y. 360, 160 N. E. 92 (1914).

⁵⁴ Indeed, the *Equitable Life* case, note 53 *supra*, involved dividends from realized gain on sale of a fixed asset at a time when the statutes of both New York and Utah (not discussed in the opinion) contained such a prohibition.

⁵⁵ See discussion p. 263 *supra*.

it seems pretty well agreed that unrealized appreciation of at least fixed assets, whatever else it be, is not profits⁵⁶—and especially not profits “arising from the business.”⁵⁷ If the statute is a surplus or profits statute, we still have the difficulty as to whether both of these sources are limited by the phrase “arising from the business.” Finally, even if a permissible dividend source is plain “surplus” not limited by that phrase, the former assurance seemingly prevalent that unrealized appreciation of fixed assets does not produce a surplus available for dividends,⁵⁸ has been somewhat shattered by the full attention given to the problem in a notable New York case.⁵⁹

Query whether any light is thrown on the problem under discussion by the remark in the *Wiscasset Mills* case that:

“Manifestly, for the purpose of determining the amount to be declared and paid as a dividend, it is necessary that the true value of the assets in cash, and not the mere book value, should be ascertained, for no dividend can be lawfully declared and paid except from the surplus or net profits of the business. C. S. §1179. The terms ‘net profits’ or ‘surplus profits’ have been defined as what remains after deducting from the present value of all the assets of a corporation the amount of all the liabilities, including the capital stock.”⁶⁰

If the court, in the second above quoted sentence, really meant that unrealized appreciation of fixed assets produces *profits* (whether “net profits,” “surplus profits” or otherwise), one would be inclined to comment critically and adversely. But it would be unfair to ascribe any such intention to a court which was facing an utterly different problem and had no reason to have in mind the problem under discussion.

Tenth hypothetical case: unrealized decline in value. Let us assume, again, that our corporation owns and operates apartment houses carried on the books at cost, less physical depreciation, but with the tables now turned: these houses were acquired in a period of high real

⁵⁶ In Am. Inst. of Accountants, Acc. Res. Bull. No. 5 (April, 1940) one finds diverse views expressed as to what may be done with unrealized appreciation of fixed assets but, apparently, there is general agreement that it is not to be viewed as profits or income. See also, SANDERS, HATFIELD & MOORE, STATEMENT OF ACCOUNTING PRINCIPLES 40 (1938); KATZ, ACCOUNTING 119 (1954); GRAHAM & KATZ, ACCOUNTING IN LAW PRACTICE 210 (2d ed. 1938); Southern California Home Builders v. Young, 45 Cal. App. 679, 188 Pac. 586 (1920); Randall v. Bailey, 288 N. Y. 280, 43 N. E. 2d 43 (1942); Hill v. International Products Co., 129 Misc. 25, 220 N. Y. Supp. 711 (Sup. Ct. N. Y. Co. 1925).

⁵⁷ Weiner, *Theory of Anglo-American Dividend Law: American Statutes and Cases*, 29 COL. L. REV. 460, 475 (1929).

⁵⁸ KEHL, CORPORATE DIVIDENDS 100 (1941).

⁵⁹ Randall v. Bailey, 288 N. Y. 280, 43 N. E. 2d 43 (1942). See also the careful opinion in the lower court, 23 N. Y. S. 2d 173 (1940).

⁶⁰ Cannon v. Wiscasset Mills Co., 195 N. C. 119, 125, 141 S. E. 344, 348 (1928).

estate prices and now we are in a period of low real estate prices; by some test, on which let us agree for purpose of argument, the corporate assets are now worth \$100,000 less than the figure at which they are carried on the books. The books, we assume, showed no deficit and no surplus at the beginning of this fiscal year; at the end of the year they show an operating profit for the year of \$10,000. Can \$10,000 lawfully be paid out in dividends?

We pass over the question, already discussed, whether our dividend statute permits dividends from current profits insufficient to recoup past operating or non-operating *realized* losses; we assume, for the purpose of argument, that the answer is no. That still leaves the question: must these fixed assets be written down to reflect the current low values? After all, our hypothetical corporation still has the same physical fixed assets (less physical depreciation, duly reflected on the books) that it started with (or we can so assume for purposes of argument), it has no past operating deficit to make up, and it is making money. Why not, then, permit a dividend? If the decline in value is merely a general price decline, what is the point in forcing the assets to be recorded in a smaller number of bigger dollars? If the decline is peculiar to these assets, still how do we know that this decline is ever going to be actually realized or to be felt by the business except in the level of current and future profits? "Unrealized declines in capital assets, other than those to be provided for by depreciation [physical], are not ordinarily to be recorded."⁶¹ Anyhow, will not the shareholders suffer enough as it is, since the lower values indicate that future profits will be less? One gets little help from the judicial decisions. The lower court in that New York case which recognized a dividend source in surplus from unrealized appreciation of fixed assets expressed the view that, for the same reasons which show that unrealized appreciation must be considered, unrealized *depreciation* must also be taken into account.⁶² But query to what extent that court's view represents the general view with respect to unrealized appreciation and, hence, to the corollary which the court believed to be the logical accompaniment, viz., unrealized decline. In the depression of the thirties, industrial corporations did not, so far as one recalls, feel compelled to write down their capital assets to reflect current prices and, correspondingly, to go through a capital reduction so as to make available for dividends such current profits as they then might be earning. (A number of corporations resorted to capital reduction in the thirties to wipe out operating deficits, or resorted to write-downs of assets for

⁶¹ SANDERS, HATFIELD & MOORE, STATEMENT OF ACCOUNTING PRINCIPLES 40 (1938). (At the time this work appeared, the problem was far from academic.)

⁶² *Randall v. Bailey*, 23 N. Y. S. 2d 173 (Sup. Ct. N. Y. Co. 1940), *aff'd* without opinion, 262 App. Div. 844, 29 N. Y. S. 2d 512 (1st Dept. 1941), *aff'd* with opinion, 288 N. Y. 280, 43 N. E. 2d 43 (1942).

the dubious purpose of making a better showing on their current profits by lowering their depreciation charges, but that is another matter.) The writer recalls that counsel for corporations that were investment trusts did, in the thirties, advise those corporations which wanted to pay dividends from the current income earned on their portfolios to go through a capital reduction, but the assets of an investment trust (usually, listed securities) are different from apartment houses or a steel mill in that the current market value of the portfolio is readily established and the portfolio in a sense more closely resembles *current* assets, with the corresponding "lower of cost or market" accounting convention that has found accounting and judicial acceptance in the case of current assets.⁶³ Indeed, the only judicial decision requiring a write-down, for dividend purposes, of corporate assets because of unrealized decline involved a corporation whose assets consisted of stocks and bonds,⁶⁴ even though they apparently were held for investment, and this case relied heavily on *Randall v. Bailey*.⁶⁵

One might ask, however: is not the problem under discussion eased by the discussion in the *Wiscassett Mills* case, wherein the court said (see remarks quoted *supra* p. 276) that for dividend purposes it is necessary to take "the true value of the assets, in cash, and not the mere book value"? But the problem which the court had before it was whether management is justified in taking into account the wear-and-tear depreciation in fixed assets before computing the accumulated profits which, under G. S. 55-115, must under certain circumstances be paid out in dividends. Query whether one is justified in predicting, on the basis of undeviating adherence to these words taken literally and out of context, that the court will blindly apply them to the problem under discussion, against the established practice of carrying fixed assets at cost less physical depreciation.

Conclusion. The foregoing ten hypothetical cases reveal only a few of the difficulties and uncertainties relating to the sources available for dividends under the present dividend statute. Even so, this discussion has been held to a very simple level. We have not discussed the bearing of multiple classes of shares (*e.g.* preferred and common) on the construction of the sources of dividends permitted by the statute. (Particularly pertinent in wasting asset corporations.) Nor have we discussed the question whether the sentence in G. S. 55-66 that "no such decrease of capital stock decreases the liability of any stockholder whose shares have not been fully paid, for debts of the corporation theretofore contracted" raises an implication that pre-existing creditors can go

⁶³ *Branch v. Kaiser*, 291 Pa. 543, 140 Atl. 498 (1928).

⁶⁴ *George E. Warren Co. v. United States*, 76 F. Supp. 587 (D. Mass. 1948).

⁶⁵ Note 59 *supra*.

against shareholders who get dividends from a reduction surplus. Nor have we discussed the potential difficulties in the dividend statute's provision against dividends when the corporation's "debts, whether due or not, exceed two-thirds of its assets" (three-fourths in case of public service corporations). (Under that provision, what about the corporation's obligations under long-term leases, pension plans, etc? And for the application of that ratio provision, is the "true value" of the assets arguably mandatory, however unsatisfactory the "true value" standard be ordinarily for determining surplus?)

Except for the problem of the unrealized decline in value of fixed assets, all of the problems here discussed find a fairly definite answer in the new Business Corporation Act enacted in 1955 to become effective on July 1, 1957. Even that problem finds therein certain guides, such as the propriety of carrying assets on the books, for dividend purposes, in accordance with generally accepted principles of sound accounting practice (which may not coincide with "true value"), except where the financial situation is so bad that actual insolvency is in the picture. Even the new Act, of course, will not afford a quick and certain solution to many other problems, some of them created by the deliberate policy choices of the new dividend provisions. (For example, under the new *current profits* alternative source of dividends, if a profit is *realized* this year from the sale of a fixed asset, is that net profits *earned* during this year or should it be allocated over the years in which the appreciation took place?) What has been said would seem to indicate, it is believed, not only that the present dividend statute is inadequate but that the inadequacies cannot be cured by adding a word here or a comma there. A complete overhaul is indicated. Perhaps this presentation leads to a suspicion (well founded, it is submitted) that a similar discussion of problems in other areas of corporation law would suggest a similar conclusion with respect to the inadequacy of the corporation law that is in effect at the present time.